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Aid Modalities Matter: The Impact of Different World Bank and IMF Programs on Democratization in Developing Countries

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Abstract

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Introduction

For decades, donors have provided large volumes of foreign aid to countries like Mobutu's Zaire, Marco's Philippines, and Mugabe's Zimbabwe. In some instances, aid cemented the firm grip of these dictators over their countries. This is why aid – just like certain natural resources like oil or minerals – is often considered a curse rather than a blessing (Wright and Winters 2010:69-70). However, these negative examples can be contrasted with a number of other cases where aid recipients have experienced a successful transition to democracy. Under which conditions is aid a blessing rather than a curse with respect to democratization?

We argue that not all resources are the same, and this also applies to foreign aid. For example, the effect of natural resources is known to depend on the required extraction technology (e.g., Girod 2012:190). Generally, resources are problematic when they create cash flows that can be easily appropriated by autocratic rulers. For aid, the latter depends on the degree of fungibility. To the extent that aid is fungible, it can be (re)allocated by autocratic regimes for their own purposes. Since governments can readjust the allocation of their own national resources in line with the external aid inflows, even if aid is earmarked for specific activities (Bader and Faust 2014; Boone 1996; Kosack and Tobin 2006), aid contributes to political leader survival (Bueno de Mesquita and Smith 2010; Kono and Montinola 2009), thereby stabilizing the current regime (Dutta, Leeson and Williamson 2013; Morrison 2007, 2009).

However, foreign aid does not always come free of conditions, and some of these conditions may limit fungibility, notably when they directly focus on participative processes and government accountability. Recent field experiments in developing countries confirm that enhancing the transparency of public policy, and providing opportunity for public scrutiny, can have substantial effects on political behavior (for an overview, see Humphreys and Weinstein 2009). Those studies find, for instance, that the threat of an audit reduces corruption (Olken 2005), and that citizen oversight has a powerful effect on the quality of local health care delivery (Bjorkman and Svensson 2009). When accountability is increased, for instance in response to the conditions of a specific aid program, public agents that may have otherwise diverted resources for their own private goals, feel compelled to use these resources for the benefit of the general public. This is exactly the process we have in mind when we refer to limitations of fungibility as an implication of appropriate conditionality.

Girod (2012) also refers to the potential of aid conditional on reform, but shows that donor-imposed reform requirements may not be taken seriously by recipient governments if they have other resources to replace the aid flows. While she focuses on the fungibility of natural resources, our focus is on the fungibility of aid resources themselves. Moreover, to our knowledge, this is the first study to examine the argument by differentiating between different types of aid. The discussion thereby contributes to the strand of 'resource curse' (and 'aid curse') literature that looks at the specific conditions under which these resources can be beneficial (Colgan 2010, 2011; Girod 2012). In a similar way, it contributes to the development of a more nuanced literature on the effect of conditionality. This literature goes beyond a general cross-the-board assessment of whether it is successful or not, but typically differentiates with respect to institutional and political conditions in recipient countries rather than with respect to different types of conditionalities attached to aid (e.g., Beazer and Woo 2015).

Our paper combines insights from the conditionality and resource fungibility discussion and introduces them into the aid and democratization literature. The role of conditionality for the effect of aid on democratization is best examined by studying the different lending instruments of the two major international financial institutions (IFIs): the World Bank (WB) and the International Monetary Fund (IMF). They are large donors and their policies are often followed by bilateral donor agencies, which further scales up the effect to be observed. Their assistance often comes along with specific conditions on economic and institutional reform that – despite statutory prohibitions against political interference – must be expected to have political consequences for recipient nations (see Killick 1995).

Given the variety of conditionalities attached to the IFIs' different lending instruments, we expect some variation in whether they pave or undermine the way to democratization. Those aid types that come with requirements that indirectly limit fungibility, e.g., through increased accountability of political leaders, should have a positive effect on democratization. In contrast, those aid types that do not come with such conditions should have a negative effect on democratization. To examine these differences, we sort the different aid activities into four major categories of lending instruments: (i) World Bank Investment Projects (INV), (ii) IMF Stabilization Programs (STB), (iii) the institutions' Structural Adjustment Programs (SAP), and (iv) their more recent lending based on the Poverty Reduction Strategy (PRS) approach.

Using panel data for a sample of 100 developing countries over a period of 30 years, and controlling for a number of alternative explanations, we offer suggestive, but robust evidence for the different effects of aid depending on its conditionality. In the example of IFI lending, where the different types of conditionality can be distinguished most clearly, we show that those aid types that come with conditions that (indirectly) limit fungibility have a positive effect on democratic regime transition (PRS, and possibly SAP), while the other aid types show no, or even a negative effect.

These results are relevant beyond the context of development cooperation as they point to general institutional mechanisms promoting democratization. If such mechanisms can be installed, the negative effect of resources other than aid addressed in the traditional resource curse literature might also be mitigated. Moreover, given that the IFIs make an active choice within their menu of lending types, our results can also be used to assess the performance of these international organizations (IOs) along the lines suggested, e.g., in Gutner and Thompson 2010.

The remainder of the paper is organized as follows: We first review important contributions of the aid and democratization literature. This is followed by a presentation of our theoretical framework and its implications for the relationships between the four different lending types and democratization. In the remaining sections we discuss the data and operationalization of our hypotheses, introduce our econometric estimation strategy, and present the results. The last section concludes.

Earlier research on aid and democratization

Existing research on aid and democratization can be divided into three, at times overlapping, strands: pessimistic, optimistic, and conditional. Aid pessimists argue that foreign aid has a negative effect on democracy, because it makes governments less accountable to their citizens. According to them, foreign aid is a highly fungible resource and similar to other forms of non-tax revenues, particularly oil and other rents from mineral extraction. Foreign aid reduces a government's need for taxation, which normally exhibits greater levels of public scrutiny and cannot easily be appropriated by the ruling elite (see, e.g., Djankov, Montalvo and Reynal-Querol 2008; Knack 2004; Wright and Winters 2010).

Conversely, aid optimists argue that aid is different from oil and other non-tax revenues. While these scholars generally acknowledge the negative baseline effect of non-tax revenues (including aid) on democratization, they argue that aid agencies have added value to the resource transfer. A positive effect of aid on political regime is attributed to the objective and the modalities that make aid money less fungible than the rents generated from natural resources (Goldsmith 2001; Dunning 2004; Collier 2006; Bermeo 2011). In particular, aid specifically intended to improve government accountability and democratic institution appears to have a positive effect (Aronow, Carnegie and Marinov 2012; Finkel, Pérez-Liñán and Seligson 2007; Kalyvitis and Vlachaki 2010; Nielsen and Nielson 2010; Scott and Steele 2011;).

Many of these more optimistic studies belong to a conditional strand within the aid effectiveness literature, which suggests that the impact of aid on democratization depends on conditions attached, the nature of the recipient's regime, donor intent, and the time period allowed for aid to become effective (see Bermeo 2011; Dutta et al. 2013; Kersting and Kilby 2014; Kono and Montinola 2009; Montinola 2010; Morrison 2007, 2009; Wright 2009; Licht 2010). Conditions attached to aid may force the government to move towards better governance, but may also release the government of its responsibility towards its citizens, and substitute accountability to the public with accountability to donor agencies. When aid is conditional on good governance, recipient governments seem to respond to these incentives (Dreher, Öhler and Nunnenkamp 2012; Kersting and Kilby 2014).

The analysis of different types of conditionality should be particularly relevant for IFI lending, where it is amply applied and used in a variety of forms ranging from simple project specific conditions to large-scale economic and institutional reforms (policy and process conditionality). Yet, even generally, the effect of IFI lending on democratization has only been examined in a few academic studies thus far, perhaps because of the politically neutral appearance cherished and cultivated by the IFIs. Barro and Lee examine the effect of the IMF's stabilization programs on a number of different economic and political outcome variables including democracy. Looking at developments over a period of five years they find a small negative effect (Barro and Lee 2005:1266). By contrast, econometric results by Nelson and Wallace (2005:22-23) suggest that countries undergoing IMF programs show significantly stronger democratization and an increasingly positive trend over time. Abouharb and Cingranelli's (2007a,b) path-breaking analysis on the IFI's human rights impact finds that longer exposure to structural conditionality is positively correlated with procedural democracy. However, it is negatively correlated with a wide range of civil, worker and human rights that may be associated with substantive democracy. Some additional studies on the IFIs' impact on democratization exist, but they are constrained by more limited data coverage regarding time and geographical focus (Brown 2009; Moore and Scarrit 1990).

In the following section, we will argue that some of the seemingly contradictory effects observed in the existing studies could be related to different types of IFI conditionality associated with alternative lending instruments, and to the related effect on the fungibility of aid resources.

Aid, fungibility, and the impact on democratization

Economic development can foster democratization though different mechanisms, as discussed in the literature building on the modernization thesis (Lipset 1959; Przeworski, Alvarez, Cheibub and Limongi 2000). Several scholars have argued that democratization is a strategic choice by the elite to maximize its welfare. Democratization is most likely if elites feel less threatened because of low inequality or high capital mobility (Boix 2003), elites are willing to make concessions to citizens in order to stay in power, and citizens are able to institutionalize their power (Acemoglu and Robinson 2006), or if the elite can get the opposition inside the regime (Gandhi and Przeworski 2007). Put differently, democratization generates winners and losers, and in order to consolidate, "democratic institutions must at the same time protect all major interests (…)" (Przeworski 1991:188).

Foreign aid constitutes an important source of income for many developing countries. Thus, the question emerges how aid interferes with the mechanisms described above. Bueno de Mesquita and Smith (2009) show that the effect of aid programs depends on their impact on leadership and policy. The authors illustrate that leaders of countries that receive aid choose policies and resource allocations that protect their hold on power. To the extent that such policies and allocations are compatible with good economic or social performance, they will make decisions that are social-welfare enhancing. However, if faced with a contradiction between actions that enhance their own political welfare – e.g., transfers to their clientele (say, the 'elite') – and actions that advance societal well-being, recipient leaders will select the former. Transfers to the elite will help the existing regime to survive so that it can continue to pursue the same policy choice in the future. Consequently, citizens in these recipient countries have to face "bad policies" and "bad leaders" (Mesquita and Smith 2009:336). A growing literature now confirms that aid improves political leader survival (Bueno de Mesquita and Smith 2010; Kono and Montinola, 2009), thereby stabilizing the current regime (Dutta et al. 2013; Morrison 2007, 2009).

While this holds irrespective of whether the country is governed democratically, our focus is on the difficulties that aid may present by stabilizing autocracies. The basic problem in this context is that aid is fungible, so that autocratic regimes can (re)allocate aid for their own purposes. Since governments can readjust the allocation of their own national resources in line with the external aid inflows, they can reallocate the funds even if aid is earmarked for specific activities (Bader and Faust 2014; Boone 1996; Kosack and Tobin 2006). Thus, fungibility may contribute to autocratic survival as it offers an avenue for patronage, repression, and demobilization of threatening interest groups.[1]

We contribute to this debate by showing that not all types of aid are equally fungible. Fungibility may be constrained by policy and, even more so, process conditionality in ways that have not yet been fully explored in the literature. While the general problems related to conditionality are well-known (see, e.g., Wright and Winters 2010), conditionality can still limit the incumbent's freedom of choice between his own political welfare and actions that advance societal well-being. Policy conditionality directly relates to the economic policies adopted by the recipient government, and process conditionality relates to reforms in the political decision making process itself, notably to the role of the elite versus the general population within this process, and to the interaction of different parts of the executive branch. In such a context, diverting resources becomes politically costly, and therefore, indirectly, these resources become less fungible. Put differently, a state is not a unitary actor, and where conditionality strengthens civil society and increases the involvement of other state actors in the resource allocation process (through vertical and horizontal accountability of the government), it can increase the number of actors able to constrain fungibility.

Different aid types come along with specific policy and process requirements. As a consequence, the above discussion leads to different predictions regarding the effect of each of these aid types on democratization: Elites (in autocracies) will only accept aid if they believe it will help or at least not hamper their survival. The extent to which those elites are able to leverage these external resources for their own purposes, however, depends on the types of aid. Those aid types that come with policy requirements that indirectly limit

[1] The problem of aid fungibility is closely related to the issues described as the "resource curse". For a discussion see Humphreys (2005) and Bueno de Mesquita and Smith (2009).

fungibility will have a positive effect on democratization. In contrast, we expect those aid types that do not come with such conditions to have a negative effect on democratization.

Before we discuss the different aid types and their expected effect, let us illustrate the above discussed mechanism with an example. Michaelowa (2011:464-465) describes the case of Malawi, where the IMF had set a ceiling for public expenditure, which was then translated into corresponding sector budgets. In order to strengthen local ownership, to improve transparency and to enable the ministry to carry out reliable mid-term financial planning, other donors considered replacing traditional project aid with joint education sector budget support. This could have enhanced democratic accountability. However, IMF conditionality purely focusing on (fiscal) accountability towards the multilateral lending agency prevented this effect. The donors' intention to support education through the budget itself had become impossible, because – as a consequence of the indirect limitation of the sector budget by the IMF – the government's own spending on education would have been cut accordingly ("fungibility by construction"). In sum, the IMF intervention invited fungibility and prevented potential democratic development in this case. Only an increased emphasis on cooperation between ministries, notably the finance ministry and the education ministry, eventually led to the discovery of this problem and provided the necessary incentives to search for solutions. What the example also shows is the crucial role of coordination between the different aid agencies. If they do not cooperate, conditionality (like the limitations of the budget by the IMF) can also be counter-productive.

Different World Bank and IMF program types and their expected effect on democratization

Based on common characteristics regarding their aid modalities, we now identify the four types of lending programs according to which we will categorize the multiple financial instruments used by the IFIs. Two questions guide this classification: First, does the financial instrument belong to the World Bank's or the IMF's traditional core business with the individual organization's own particular aid modalities, or does it reflect the move of the IFIs towards collaboration through similar objectives (notably long-term economic development and poverty reduction) and/or coordinated conditionality of their programs? Second, for the more collaborative programs: are they conditioned exclusively on the implementation of particular policies, or do they also include process conditions with regard to the formulation of these policies (ownership, civil society participation)? These guiding questions lead us to the distinction of the following general program types: *(1) World Bank Investment Projects (WB-INV), (2) IMF Stabilization Programs (IMF-STB), (3) IFI Structural Adjustment Programs (IFI-SAP),* and *(4) IFI Poverty Reduction Strategy Programs (IFI-PRS).* Table 1 provides an overview of their different characteristics and the individual lending instruments subsumed. For further details on our classification procedure, and on the various financial instruments taken into account, see "Supplementary File" Annex 1.

In the following the four different program types with their specific conditionalites will be discussed one by one, to identify the implications for the fungibility of aid and democratization.

Table 1: *Types of IFI program lending*

Introduced	Program	Eligibility	Focus	Conditions	Duration	Instruments
1946	Investment project (WB-INV)	All WB members	Infrastructure & production	Project-specific (safeguards)	5-10 years	WB: Specific Investment Loan, Sector Investment and Maintenance Loan, Financial Intermediary Loan and Technical Assistance Loan
1952	Stabilization program (IMF-STB)	All IMF members	Balance of payments	Policy (fiscal reforms)	1-3 years	IMF: Stand-by Arrangement, Extended Fund Facility, Flexible Credit Line
1980	Structural adjustment program (IFI-SAP)	Only low-income countries	Economic growth	Policy (structural reforms)	3-4 years	WB: Sector Adjustment Loan, Structural Adjustment Loan, Programmatic Structural Adjustment Loan, Special Structural Adjustment Loan; IMF: Structural Adjustment Facility, Enhanced Structural Adjustment Facility
1999	Poverty reduction program (IFI-PRS)	Only low-income countries	Poverty reduction	Process (governance reforms)	3-4 years	WB: Poverty Reduction Support Credit; IMF: Poverty Reduction and Growth Facility, Extended Credit Facility

World Bank Investment Projects (WB-INV)

The World Bank's investment project financing (WB-INV) represents a majority of the Bank's lending portfolio and has constituted its core business since 1946. Investment projects aiming at building the physical and social infrastructure of a country have a medium to long-term focus (5-10 years) and, in general, only project-specific requirements attached.[2] Similar to most bilateral aid funds, investment projects provide funding to the government to cover specific expenditures related to the implementation of the project or the quality of assets being financed. The accompanying legal agreement sets forth the contractual obligations for both parties, including prerequisites for disbursement as well as project-specific standard and non-standard covenants, such as Bank-mandated fiduciary, and environmental and social safeguard policies. Investment project financing is most widely used in the infrastructure, human development, agriculture, and public administration sectors.

[2] An internal Bank report (2006:10) shows that in the mid-1990s, the complexity of investment projects grew, and they increasingly covered a wider range of activities within a sector, and had corresponding sector policy conditions attached. This resulted in a convergence of structural adjustment programs and investment projects. Due to streamlining efforts, however, the number of investment operations with sector policy conditions was brought down again from 25% to 3% within ten years.

Since generally, no political or process conditions are attached to these financial flows, the borrower government may reduce own spending in this area, and use these funds for setting its own priorities without externally induced limitations. As a consequence, the incumbent is not constrained in distributing rents to his own clientele at the cost of the general population. Furthermore, investment finance is generally disbursed without any consideration of power relations within the state. Investment projects are negotiated between the executive and the representatives of the World Bank, while the legislative does not take part in the negotiations (Abouharb and Cingranelli 2007b:204). As a result, these projects are often funded outside the budget without being subject to parliamentary review. This reinforces already existing deficiencies in democratic oversight, and leads to the fungibility of aid inflows due to lack of transparency.

We conclude that aid in the form of investment projects financing is highly fungible and may hence hamper, rather than encourage, democratization.

IMF Stabilization Programs (IMF-STB)

The IMF's core business (IMF-STB) traditionally centers on financial assistance to member countries during a crisis, when they face temporary balance of payments difficulties. Program duration of these financial instruments is thus usually restricted to 1-3 years. In return for balance of payments support, the IMF typically requires that the borrower government initiates fiscal, monetary and social reforms aimed at restoring balance of payments viability and maintaining macroeconomic stability.[3]

[3] For details on the typology of conditions, see IMF website and IEO (2007:4).

The conditions associated with those stabilization programs, like raising taxes and cutting expenditures, currency devaluations, and pension reforms, affect large parts of the population and are likely to cause social protest (Brown 2009:436). However, what seems to matter most is that the Fund's capital infusions bail out political leaders under stress. Autocrats may thus use the money to cement their place in power and blame the IMF for unpopular policies (Vreeland 2003:13). Furthermore, it is often argued that countries facing a financial crisis need to reform their economy first, before they address their political problems (Bueno de Mesquita, Smith, Siverson and Morrow 2003:477). The IMF may thus prefer to establish working relations with governments that are powerful enough to push through "unpopular but necessary" reforms (Kalinowski 2007:346). In crisis situations, governments often rule per emergency law. Political decisions are taken by decree or pushed through the legislature (Przeworski 1991:184).

The financial assistance from the Fund's stabilization program is fungible because the conditions attached do not increase state actors' awareness of, and involvement in, the resource allocation process. On the contrary, financial crisis in combination with deficit lending reduces the power of civil society vis-á-vis the state. In addition, since working relations are primarily established with the finance ministry, other parts of the executive or the parliament are involved only to a limited extent. Just as in the case of the World Bank's investment projects, we therefore expect that the resource inflow associated with stabilization programs does not create conditions conducive to democratization. Overall, we instead expect a negative effect.

IFI Structural Adjustment Programs (IFI-SAP)

Collaboration between World Bank and IMF to support their country members' structural adjustment programs started in the 1980s and has increased since then. Both IFIs have joint guidelines, which help to ensure that their respective support is consistent by combining the specific expertise and financial resources of each institution.[4] Structural adjustment programs can be stand-alone, but are more often part of a programmatic series of operations providing budget support to borrower governments, in which a medium-term program (3-4 years) of policy or institutional reform is supported. Funds are disbursed against the completion of structural and institutional reforms that traditionally cover the sectors trade and economic management, agriculture and infrastructure, and financial and private sector development (Koeberle et al. 2005:63; IEO 2007:5; World Bank 2007:6).

Even though these reforms tend to weaken the role of the state in all economic activities (e.g., through privatization of state-owned enterprises and civil service reform) the power of the state elites vis-á-vis civil society might not be constrained, as adjustment loans significantly increase the size of non-tax revenues. This enables political leaders to comply with structural reforms and, at the same time, to use at least some of the assistance to secure their grip on power (Bueno de Mesquita and Smith 2007:254). However, the IFIs possess significant leverage since they can credibly commit to withhold their funds in case of non-performance. This is even more so when they coordinate their intervention. As institutional reforms – e.g., introducing transparency and increasing efficiency in the public and private sectors – have often been part of the deal, oversight and regulation agencies may gain some power within the state apparatus (Brown 2009:477; Cull and Effron 2008:316). Moreover, recipients of adjustment lending are typically not facing solely temporary balance of payment needs, rather, they are in prolonged financial distress, a situation that cannot be managed by emergency law, but requires adequate domestic political debate.

[4] See Koeberle, Bedoya, Silarszky and Verheyen (2005:76) and the report of the external review committee on Bank-Fund collaboration (IMF and World Bank 2007), which survey the evidence.

Taken together, we expect that the policy conditions that are attached to the adjustment lending works towards a small positive effect on the power balance within the state. The negative effect due to the "foreign-aid-for-policy deals" (Bueno de Mesquita and Smith 2007:251) should be compensated by the direct effect of institutional conditions. It follows that these programs' policy conditions reduce the fungibility of structural adjustment lending and thus overall effect on democratization should be (weakly) positive.

IFI Poverty Reduction Strategy Programs (IFI-PRS)

Over time, collaboration between World Bank and IMF has become more systematic in regard to their poverty-focused lending instruments. Poverty reduction lending is similar to structural adjustment lending in that these lending instruments also come in the form of programmatic support for medium-term policy and institutional reforms. However, poverty reduction programs differ significantly from adjustment operations in that they support country-owned strategies aimed at achieving sustainable growth and, in particular, poverty reduction. Moreover, the nature of conditionality has changed considerably. Both IFIs have moved away from conditionality in regards to privatization, civil service and trade reforms, and the main focus here lies on public sector governance reforms (see Koeberle et al. 2005:62-63; IEO 2007: 5,16-17).

At least in principle, lending is made conditional on the foregone participation of civil society in the PRS process (process conditionality). It is expected that societal actors use this political space to engage in policy dialogue and to oppose the arbitrary use of state power. Furthermore, the IFI have moved beyond the removal of economic distortions towards building complex institutional infrastructure in recipient countries. For example, they focus on revenue administration, expenditure auditing, accounting, fiscal transparency, and parliamentary oversight. All these measures aim at making public financial flows more transparent and installing appropriate checks and balances on central government behavior.

Among all program types, poverty reduction lending should be the least fungible. The process conditionality attached to this form of aid increases the accountability of the government with respect to other state actors. Overall, we thus expect poverty reduction lending to have a positive effect on democratization.

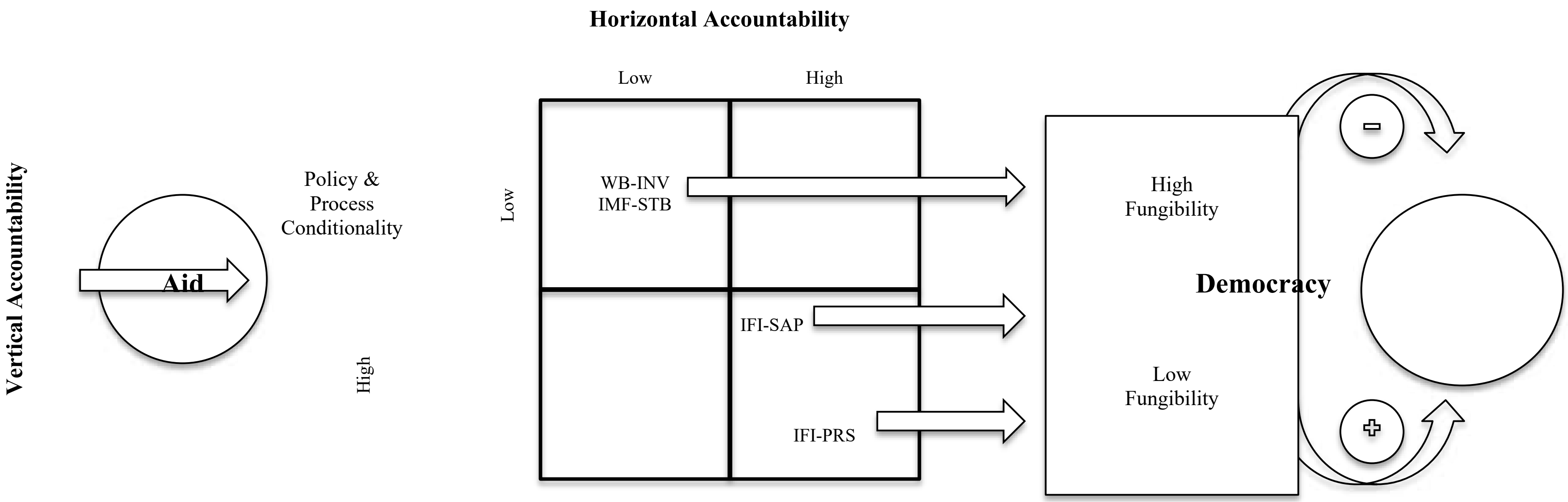
We can sum up the theoretical discussion with the following observations (see Figure 1):

- The "traditional" lending approaches (WB-INV and IMF-STB) should have a negative effect on democratization as is aid is highly fungible.
- Poverty reduction programs (IFI-PRS) are expected to have a positive effect on democratization as fungibility is substantially reduced.
- The effect of structural adjustment programs (IFI-SAP) on democratization is positive but small, as fungibility is only partially limited.

Data and operationalization

To explore the impact of different types of World Bank and IMF programs, we undertake a panel data analysis based on annual data from 1980 to 2011 for approximately 100 low- and middle income countries. Some data are not available for all countries or years, so that the panel is unbalanced and the exact number of observations depends on the choice of variables. In the following, we will only briefly discuss the different variables used. More details can be found in "Supplementary File" Annex 1.

Figure 1: *Flow chart - Aid, fungibility, and democratization*



Dependent variables

Democratization in our paper is best understood as an incremental process, whereby a political regime changes from autocracy towards democracy. From a theoretical perspective, it is difficult to define threshold values for democracy, autocracy, or hybrid regimes. Another difficulty is that the change in the quality of democracy is two-way and the movement may also occur towards more autocracy. We therefore rely on the polity2 regime indicator, which measures the quality of a political regime on a continuous scale from -10 (hereditary monarchy) to +10 (consolidated democracy). It includes both, the vertical and the horizontal dimension that have been considered in our theoretical analysis (for more details, see Marshall, Jaggers, and Gurr 2011). We rescale the variable to range from 0 to 20. As we are interested in explaining a move towards democracy, rather than a given level of democracy, we need to specify a dynamic model, and we do so by introducing the lagged dependent variable as a control for the level of democracy at the beginning of each period.

Explanatory variables

Participation in IMF-STB, IFI-SAP, or IFI-PRS is measured by a dichotomous variable for each program type in any specific year. The variable equals 1 if a country is financially supported by at least one of the lending instruments included in this program type (at any time of the year), and 0 otherwise. With this dichotomous coding scheme, we follow Vreeland (2003:18) as many others (e.g., Nooruddin and Simmons 2006; Sturm, Berger, and de Haan 2005). As opposed to the other three program types there is only little variation in the dummy variable for WB-INV, with an average of 83 countries participating per year. This particularity can be attributed to the combination of long investment duration with high frequency of project occurrence. We deal with this problem by recoding WB-INV as a categorical variable, regrouping investment projects into four types of financial instruments covered by the Bank's Operational Policy (i.e. Specific Investment Loan, Sector Investment and Maintenance Loan, Financial Intermediary Loan, and Technical Assistance Loan) and reporting the sum of the types used for a country in any specific year.

Control variables

In selecting our control variables, we rely on prior theory and research on structural conditions for democratic transitions (Doorenspleet 2004; Epstein, Bates, Goldstone, Kristensen and O'Halloran 2006; Gasiorowski 1995), on democratic diffusion (Brinks and Coppedge 2006; Rudra 2005; Wejnert 2005; Starr 1991; Starr and Lindborg 2003), and on democracy promotion by foreign actors (Bräutigam and Knack 2004; Finkel et al. 2007; Knack 2004; Pevehouse 2002; Schimmelfennig and Scholtz 2008). For details on the selection of each of these explanatory variables see "Supplementary File" Annex 1.[5]

To take modernization effects into account we use GDP per capita, GDP per capita change, and the urbanization rate. Democratic diffusion processes can be thought of as global and/or regional phenomena. We measure global diffusion by the sum of imports and exports as a percentage of GDP, and regional diffusion by calculating the change in the regional average value of the polity2 regime indicator over a given period of years for each of the five regions in our sample. To proxy instability, we include the price level of consumption and an index measuring a change in the level of armed conflict intensity.

There are a number of other controls in cross-country analysis of democratization, such as dummies for particular historical and cultural heritages of developing countries (see Clague, Gleason, and Knack 2001; Linder and Bächtiger 2005). As long as these variables are time-invariant, their influence will be captured by individual country fixed effects (see below).

[5] For a meta-analysis on factors determining democratic transition, see Gassebner, Lamla, and Vreeland (2013).

Research design

In order to take into account the nested structure of our data, we use panel estimation with fixed effects. This has the virtue of addressing the problem of omitted variable bias of cross-section data by controlling for unobservable country-specific variables that are correlated with one or more of the explanatory variables. A Hausman test strongly rejects random effects for all program types, thus confirming the need for fixed effects. Our main specifications include fixed effects both for countries and for years (two-way fixed effects). Alternative estimation strategies based on panel corrected standard errors (PCSE) are discarded, as the cross-country dimension of our sample clearly dominates. Remaining within-cluster correlation is taken into account through robust estimation clustering at the country level.

As our dynamic specification requires the inclusion of the initial level of democracy, simple fixed effects regression faces the problem of Nickell bias (Nickell 1981). While Monte Carlo analysis by Judson and Owen (1999:12) showed that this bias is largely concentrated on the coefficient of the lagged dependent variable, doubts about the value of this coefficient affect the interpretation of the other coefficients even if they are consistently estimated (Birchler and Michaelowa 2013:7). This implies that the interpretation of these fixed effects models should focus on the direction and the significance of the observed effects, rather than on their exact value.

Like the aid effectiveness literature in general, we also face a large number of other endogeneity problems. If the IFIs prefer lending to democracies (which would violate their formal rules, but may still be plausible) then our model suffers from reverse causality with respect to all aid related variables. The same problem arises if demand for IFI lending is driven by the level of democracy. This would be true, for instance, if WB and IMF programs were more common in less democratic countries because such countries have fewer veto players who can oppose these programs.

Moreover, some of the control variables such as GDP are also likely to be affected by democracy. Unfortunately, convincing instrumental variables are very hard to find. As argued by Clemens, Radelet, Bhavnani and Bazzi (2012), the instruments used in the literature are generally so bad that it is more convincing to stay with OLS, while using first differences (or fixed effects), and an appropriate distinction between different types of aid. They further suggest that using two-way fixed effects can take care of most of the endogeneity concern plaguing the aid effectiveness literature, which suggests that additional instrumentation may be not only misleading, but also unnecessary.

In our case, instrumentation is even more unreliable than in the cases they consider, because we simultaneously need to instrument for four different aid variables. Hence, all attempts to obtain reasonable model specifications in this setting, either using 2SLS or GMM, were bound to fail. As in most cases of this nature, there remains considerable concern about the strength and the exogeneity of the instruments. In terms of the sign and significance of coefficient estimates, we can easily produce results in line with our hypotheses, but the validity of the overall results remains questionable when using instrumentation. Our main analysis therefore follows Clemens et al. (2012) who rely on simple two-way fixed effects without instrumentation.

Another important issue is to distinguish whether any effect we observe for the different lending programs is truly due to the nature of aid programs, or to the political climate during the period in which this instrument was primarily employed. Bearce and Tirone (2010) for instance, argue that due to reduced geopolitical constraints, conditionality could generally be enforced more easily after the end of the Cold War, so that all types of aid may have become more effective. In this case a program like the PRS may wrongly appear more effective than others, simply because it was introduced only in the late 1990s while other lending instruments were available throughout the whole period of analysis, including the difficult Cold War period. To avoid this problem, the main regression was rerun only for the period during which we actually observe PRS in the data (i.e., from 1999 onwards).

Finally, as emphasized by Clemens et al. (2012), it is important to carefully consider the time frame within which any impact of aid should be expected. The effect of IFI lending, and the conditions attached to it, on democracy can certainly not be expected to be immediate. It should take time until political decision making procedures and economic policies are adjusted, and this adjustment is what we hypothesize to bring about potential democratization (see also Kersting and Kilby 2014). We thus consider that a time horizon of five years might be a reasonable approximation. However, as there is little theoretical guidance on how long the period should be, we first compute some preliminary regressions, estimating our main specification over various time horizons (t+1, t+2, t+3, t+4, t+5). The results confirm that a five-year lag is appropriate. For all lending types except for WB-INV, the absolute size of the coefficient and the level of precision (whether significant or not) increases with the number of years these programs are in place. When change is measured within only one or two years, the overall regression is completely dominated by the effect of the lagged dependent variable (see “Supplementary File” Annex 2, Table A2.1).

Empirical results

Impact of program lending on democratization

Our results based on a five-year lag between all explanatory variables (and controls) and the dependent variable are presented in Table 2. We start with a simple regression without control that is in line with our expectation about the positive link between IFI-SAP and IFI-PRS and the level of democracy. WB-INV and IMF-STB have negative coefficients, but are insignificant. When we add our control variables, these results remain unchanged, but we observe some drop in the coefficients of IFI-PRS and IFI-SAP. When we add the lagged dependent variable in regression 3, in order to generate a dynamic model that controls for the initial level of democracy, these coefficients further drop and IFI-SAP falls slightly below conventional significance levels (p-value=12%). PRS programs are still significant, and also remain so when we restrict the time period to the years during which all the different lending programs have simultaneously been in place (regression 4) unless we additionally enter year fixed effects as in regressions 1-3 (regression 5). In regression 6 where we use the full set of observations since 1980, omit the year fixed effects, but include period dummies for the decade after the end of the Cold War (1990-1999) and the period with IFI-PRS fully established as a new lending instrument (2000-2011), we recover the positive and significant effect of both IFI-PRS and IFI-SAP. The period dummies are significantly positive, which is in line with the generally higher level of democracy in these years relative to the Cold War period. Throughout all regression specifications in Table 2, the coefficients of WB-INV and IMF-STB remain negative, but insignificant.

To some extent, these insignificant results may be driven by opposing effects of increased fungibility on which we focus here, and the democracy-enhancing effects of improved economic development (notably for WB-INV). However, it should be noted that generally, the inclusion of two-way fixed effects and a lagged dependent variable does not leave much variation in the model to be explained. This is also obvious from the lack of significant coefficients for the control variables. It is even more remarkable that IFI-PRS remains positively significant throughout, except if the period of observation is additionally shortened to the years after 1998, in which case the p-value increases to 16%. All in all, these results provide us with some confidence that the process conditionality emphasizing country ownership and civil society participation through PRS lending indeed shows some positive effect on the level of democracy, and that the positive coefficient for IFI-PRS hence captures more than just a favorable change of the general environment.

Table 2: *The impact of different IFI programs on democratization*

VARIABLES	Two-way FE	Two-way FE	Two-way FE	Country FE >=1999	Two-way FE >=1999	Period Dummies
WB-INV (t-5)	-0.01	-0.11	-0.13	-0.21	-0.17	-0.13
	(0.94)	(0.59)	(0.47)	(0.38)	(0.46)	(0.47)
IMF-STB (t-5)	-0.68	-0.51	-0.46	-0.31	-0.30	-0.59
	(0.12)	(0.25)	(0.29)	(0.44)	(0.47)	(0.17)
IFI-SAP (t-5)	1.26***	0.72*	0.58	0.21	0.22	0.73*
	(0.00)	(0.07)	(0.12)	(0.48)	(0.47)	(0.05)
IFI-PRS (t-5)	1.92***	1.31**	0.99**	0.68*	0.59	0.97**
	(0.00)	(0.02)	(0.04)	(0.10)	(0.16)	(0.02)
Polity (t-5)			0.26***	-0.03	-0.03	0.26***
			(0.00)	(0.65)	(0.64)	(0.00)
GDP per capita, log (t-5)		-1.76**	-1.19**	-0.10	-0.33	-1.06*
		(0.01)	(0.05)	(0.90)	(0.71)	(0.06)
GDP per capita change (t-5)		-0.01	-0.01	-0.00	-0.00	-0.01
		(0.49)	(0.35)	(0.61)	(0.51)	(0.42)
Urbanization rate (t-5)		-0.02	-0.02	0.09	0.04	0.00
		(0.76)	(0.71)	(0.38)	(0.71)	(0.95)
Price level, log (t-5)		-1.16*	-1.04**	-0.15	-0.12	-0.96**
		(0.05)	(0.04)	(0.76)	(0.83)	(0.04)
Trade openess, log (t-5)		0.24	0.11	-0.71	-0.83	0.25
		(0.77)	(0.88)	(0.34)	(0.33)	(0.72)
Conflict intensity (t-5)		-0.39	-0.33	-0.22	-0.22	-0.27
		(0.19)	(0.25)	(0.35)	(0.34)	(0.32)
Regional diffusion (t-5)		0.05	-0.03	0.14	0.09	0.01
		(0.76)	(0.83)	(0.66)	(0.80)	(0.89)
1990-1999						2.50***
						(0.00)
2000-2011						2.85***
						(0.00)
Observations	3,234	2,381	2,374	1,140	1,140	2,374
R-squared	0.33	0.31	0.36	0.05	0.05	0.35
Number of countries	107	100	100	98	98	100

Robust p-values (based on standard errors clustered at country level) in parentheses.
*** p<0.01, ** p<0.05, * p<0.1

Robustness tests

In order to increase the confidence in our results we carry out a number of additional regressions that are presented in Table 3. Our main interest thereby is to verify the results regarding IFI-PRS. As a first step, we rerun regression 3 of the previous table, but we omit the years during which countries have received only PRS-based lending, and have not benefitted from any other of the four lending program types. This does not change the results.

In the second regression, we examine whether it is the amount of lending or the type of lending that influences democratization. We therefore add an additional control for the volume of all lending received through the four program types. This additional variable is insignificant while IFI-PRS remains significant (with an almost unchanged coefficient). As the World Bank is often considered as some kind of a lead donor, the PRS dummy could also capture bilateral aid. In the fourth regression, we therefore include a control for the volume of bilateral aid. This alternative aid variable is also insignificant, and although the size of the IFI-PRS coefficient is reduced to 0.85, it is still relatively close to the initial value and continues to be significant.

The fourth regression controls for geopolitical considerations influencing IFI lending (see, e.g., Dreher, Sturm and Vreeland 2009a, 2009b; Kilby 2006, 2011, 2013; Stone 2002, 2004) and possibly democratization simultaneously. We do not observe any relevant changes in the results.

The final two regressions take up remaining concerns with endogeneity. Regression 5 uses a placebo test to examine potential issues of reverse causality or co-determination regarding the lending programs. While we keep the control variables for the period before we measure democracy, we exchange the timing of the lending interventions and the democracy

Table 3: *Robustness tests*

VARIABLES	(1) "Only PRS" excluded	(2) Including lending volume	(3) Including bilateral aid	(4) Including geopolitics	(5) Placebo	(6) System GMM
WB-INV	-0.14	-0.16	-0.19	-0.13	0.03	1.42**
	(0.43)	(0.44)	(0.28)	(0.51)	(0.58)	(0.01)
IMF-STB	-0.47	-0.47	-0.49	-0.44	0.07	-2.43
	(0.28)	(0.29)	(0.25)	(0.31)	(0.62)	(0.21)
IFI-SAP	0.58	0.49	0.56	0.49	0.04	-2.11
	(0.12)	(0.20)	(0.14)	(0.19)	(0.77)	(0.38)
IFI-PRS	0.94*	0.97*	0.85*	1.00*	0.19	4.94*
	(0.06)	(0.07)	(0.08)	(0.06)	(0.37)	(0.06)
Polity (lag)	0.26***	0.25***	0.24***		-0.42***	0.72***
	(0.00)	(0.00)	(0.00)		(0.01)	(0.00)
GDP per capita, log	-1.22**	-1.34*	-1.12*	-1.32	-0.00	-0.08
	(0.04)	(0.06)	(0.08)	(0.10)	(1.00)	(0.92)
GDP per capita change	-0.01	-0.01	-0.01	-0.01	-0.35**	-0.05
	(0.34)	(0.32)	(0.48)	(0.36)	(0.05)	(0.49)
Urbanization rate	-0.03	-0.03	-0.05	-0.04	0.08	0.01
	(0.66)	(0.64)	(0.46)	(0.62)	(0.71)	(0.79)
Price level, log	-1.08**	-1.00*	-1.03*	-0.98*	-0.05	-1.27
	(0.03)	(0.06)	(0.07)	(0.06)	(0.68)	(0.38)
Trade openness, log	0.04	-0.04	0.10	0.11	0.04	-1.55
	(0.95)	(0.96)	(0.89)	(0.89)	(0.44)	(0.38)
Conflict intensity	-0.32	-0.30	-0.35	-0.39	0.83***	-0.29
	(0.26)	(0.32)	(0.24)	(0.17)	(0.00)	(0.76)
Regional diffusion	-0.02	-0.04	-0.01	0.01		0.11
	(0.88)	(0.82)	(0.92)	(0.97)		(0.54)
Lending volume (INV+STB+SAP+PRS)		4.32				
		(0.15)				
Bilateral aid			2.53			
			(0.32)			
US military aid				0.003		
				(0.45)		
UNGA voting with US				1.68		
				(0.37)		
UNSC rotating member				-0.17		
				(0.64)		
Observations	2,367	2,111	2,345	2,096	2,670	2,374
R-squared	0.37	0.35	0.35	0.38	0.81	
Number of countries	100	87	100	87	100	100

Robust p-values (based on standard errors clustered at country level) in parentheses
*** p<0.01, ** p<0.05, * p<0.1
Regressions 1-4 & 6: Independent variables lagged by five years.
In regression 1, for all countries, those years in which they received only PRS lending are excluded (7 observations lost as compared to Table 2, regression 3).
Regression 5: Dependent variable (Polity) = (t-1), aid programs (INV, STB, SAP, and PRS) = (t), control variables = (t-2).
Regression 6: Hansen test for overidentifying restrictions: p = 0.70, Arellano-Bond AR(2) test for the differenced residuals: p = 0.95, number of instruments = 77. To avoid an excessive number of instruments, we collapsed them and limited the number of lags to 2 (using the Stata commands provided by Roodman 2006). Note, however, that results are extremely sensitive to changes in the specification, notably in the lag structure for the instruments.

measurement. As a result, the dependent variable is measured before the IFI interventions. If our previous result was the outcome of the IFIs selectivity, providing aid to democratic countries, rather than promoting democratization through their interventions, the coefficient should still be significant. This is not the case. The results suggest that – in line with their formal rules – IFIs do not distinguish between political regimes when they make their lending decisions. This is also consistent with Reinsberg's (2015) finding that bilateral donors react to regime change by adjusting aid allocation, while the World Bank does not.

To be sure, regression 6 presents an attempt to instrument all potentially endogenous variables. As we could not find convincing external instruments for a 2SLS model, we use system GMM, a method that has the additional advantage of being designed specifically for dynamic panel models (Blundell and Bond 1998). System GMM instruments the different variables considered as endogeneous (including the lagged dependent variable) by their lagged levels and differences. The results on IFI-PRS are in line with our previous estimations, in fact, the coefficient is now much larger than before. IFI-SAP and IMF stabilization programs remain insignificant. World Bank investment projects now show a positively significant coefficient. However, it should be noted that slight variations in the number of lags included for the instruments or other minor changes in the specification strongly affect the coefficient estimates in this model. Therefore, caution is required interpreting these results.

Our final robustness test examines the potential influence of outliers through cross-validation. We rerun Table 2, regression 3 a hundred times, each time omitting the observations of a different country. The resulting coefficient estimates and p-values for the four different lending types are presented in Figure 2.

Figure 2: *Estimation results after case wise deletion of countries*

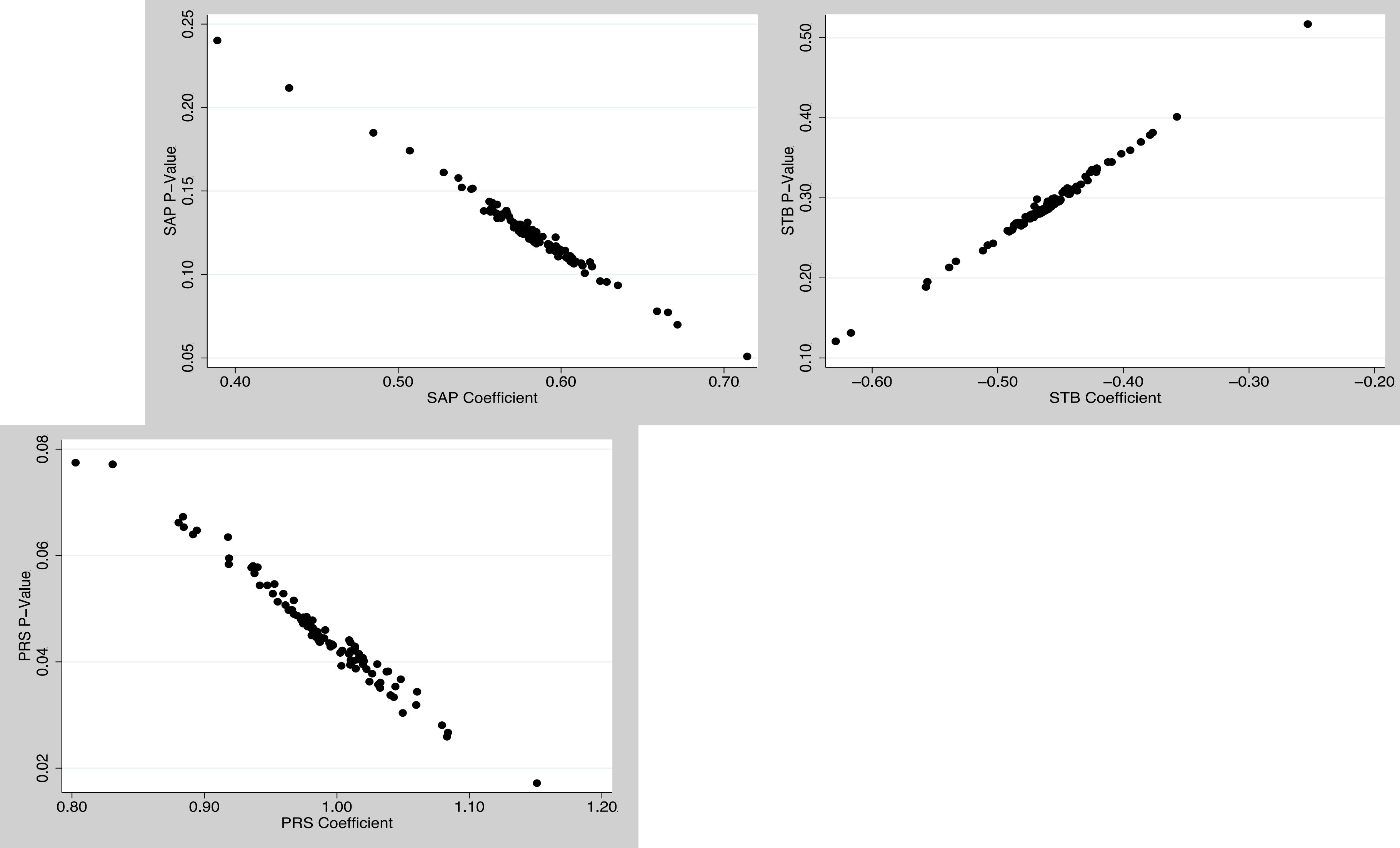


Figure based on the regression specification of Table 1, regression 3 (i.e., two-way fixed effects, and sample covering the full period).

There is no evidence that any individual country could change the general thrust of our argument. For World Bank investment projects and IMF stabilization programs, coefficients are always negative and insignificant (upper two panels of Figure 2). For the IFIs' structural adjustment programs, the coefficient estimates are always positive and turn significant when their values exceed about 0.60. For the IFIs' PRS-based lending, all coefficient estimates are positive and significant at least at the 10% level. Their values range from +0.80 to +1.15.

All in all, these robustness tests reinforce our confidence in the results of Table 2. They confirm the positive relationship between PRS programs and democratization. They equally confirm the less clear, but nonetheless positive role of structural adjustment programs. And they mostly reproduce the negative, but insignificant results for IMF stabilization and World Bank project lending. Except for the insignificance of the IMF-STB and WB-INV, these results are in line with our hypotheses about the effect of different forms of conditionality on democratization. While process-related conditionality appears to be most successful, policy conditionality can also have a limited positive effect. This corresponds to our arguments regarding the impact of these types of conditionality on the fungibility of aid inflows.

Conclusion

World Bank and IMF lending programs come along with different types of conditionality. We believe that lending instruments with suitable conditionality may also pave the way to democratization. The mechanism we propose works through a reduction of the fungibility of aid inflows. To the extent that aid is fungible, it can be (re)allocated by autocratic regimes for their own purposes. Fungibility is reduced when conditionality relates to general institutional reform, and more inclusive and transparent political decision making processes.

Our empirical analysis based on panel regressions for a sample of hundred developing countries over 32 years (1980-2011) and different types of IFI lending largely confirms these results: IFI lending positively affects democratization when it strengthens domestic accountability mechanisms and thereby reduces the fungibility of aid. This is true for PRS-based lending and SAP, albeit to a lesser extent. Otherwise, effects are largely insignificant.

From a policy perspective, these results are encouraging. While initial critiques may have been correct in pointing at the negative effect of IFI lending programs for democratization, both institutions seem to have adapted in appropriate ways to the criticism when developing their more recent instruments. While individual case studies about the PRS process usually highlight the shortcomings even within this new approach, our global, cross-country analysis indicates that at least some positive change has been achieved.

An interesting follow-up question that we could not address here is related to organizational behavior: What made these international organizations adjust their processes in the appropriate way? But also: Why did they not adjust them completely so as to even more strongly enforce recipient government accountability towards its citizens? For instance, criteria to measure accountability and civil society participation in the process of developing the country's poverty reduction strategy might deserve a more prominent place in the World Bank's Country Performance Rating (CPR), which represents the major set of indicators used for the World Bank's decisions on credit disbursements. These questions are beyond the scope of the present analysis, but could be taken up within the more general literature on the effectiveness of international organizations.

In addition, it appears relevant to assess the interplay of the IFIs with other donors. This question becomes even more relevant given the increasing activities of China as an emerging donor that is not included in the donor coordination and harmonization efforts launched in the context of the Paris Declaration in 2005. Since resources are fungible not only across government activities, but also across donors, it will be difficult to enforce reform requirements if China offers the same resources without any such strings attached. To be effective, requirements need to be based on consensus across donors, and no single donor will be able to avoid aid fungibility unless unless they are so important that their aid volumes cannot plausibly be matched by any alternative sources.

Our results demonstrate the variation in how regimes deploy different types of resources. When these resources are provided through foreign aid, the donors have the choice to select aid types that are conducive to democratization. By conditioning the resource flow on accountability and relevant reforms they can counterbalance other, negative effects of the external resources. Hence the 'aid curse' might be more easily dealt with than the 'resource curse' more generally. This is true at least, if resources are managed within the country, without the interference of external actors. However, in practice, the extraction of mineral resources in developing countries often involves foreign technology, foreign investors, and frequently, foreign aid. If the latter applies, the link between pure resource flows and policy and/or process conditions conducive to a democratic development could be introduced just as for IFI lending discussed in this paper. This would, however, also require a change of perspective for the foreign companies involved. With their focus on joint efforts on the part of developing and developed countries alike, the Sustainable Development Goals (SDGs) agreed upon within the United Nations in September 2015, might provide new incentives to move in this direction.

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